No. 78-698

In the Supreme Court of the United States

OCTOBER TERM, 1978

MANDELL SHIMBERG, JR. AND
ELAINE F. SHIMBERG, PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

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The question presented in this federal income tax case is whether the court of appeals correctly held that pro rata cash distributions received by petitioner[1] and other shareholders, pursuant to a merger of

[1] "Petitioner" refers to Mandell Shimberg, Jr. His wife, Elaine F. Shimberg, is a petitioner only because she filed a joint income tax return with her husband for the taxable year at issue.

their corporation into a larger corporation, had the effect of the distribution of a dividend, and was taxable as ordinary income under Section 356(a)(2) of the Internal Revenue Code of 1954.

The pertinent facts are undisputed and may be summarized as follows: Petitioner was the president and principal shareholder of LaMonte-Shimberg Corporation (LSC), a Florida corporation engaged primarily in building and selling single family homes. He owned, directly or indirectly, approximately two-thirds of the stock of LSC. The remaining shares were owned by 19 unrelated stockholders (Pet. App. A2, A13).

In December 1970, LSC was merged into MGIC Investment Corporation (MGIC), a large financial corporation, the stock of which was listed and traded on the New York Stock Exchange. Prior to the merger, MGIC had outstanding 6,204,448 shares of common stock held by 5,191 stockholders of record. Pursuant to the merger agreement, the LSC shareholders received ratably in exchange for their stock, 32,132 shares of MGIC common stock outright, 32,132 additional shares in escrow, and $625,000 in cash. Petitioner received 21,461 shares of MGIC stock outright, 21,461 shares in escrow, and $417,449 in cash. As of the merger, the undistributed earnings and profits of each corporation exceeded $625,000 (Pet. App. A2-A3, A13-A14).

On their joint tax return for 1970, petitioners reported gain resulting from the merger equal to the

cash they received as long-term capital gain. On audit, the Commissioner of the Internal Revenue Service determined a deficiency on the ground that the distribution of cash had the effect of a dividend and was taxable as ordinary income under Section 356(a)(2) of the Code. In this refund suit brought by petitioners in the United States District Court for the Middle District of Florida, the district court ruled that the cash received by petitioner and his fellow LSC shareholders in connection with the merger of LSC into MGIC did not have "the effect of the distribution of a dividend" within the meaning of Section 356(a)(2). It therefore upheld petitioner's claim to capital gain treatment for the cash he received as a result of the merger. In the district court's view, the test to be applied in determining whether the exchange had the effect of the distribution of a dividend "is whether the transaction resulted in a 'meaningful reduction' " of the taxpayer's proportionate interest in the corporation under *United States* v. *Davis*, 397 U.S. 301 (1970) (Pet. App. A8). Since petitioner owned 66% of the stock of LSC prior to the merger and owned less than one percent of the stock of MGIC after the merger, the district court concluded that the merger resulted in "a radical change and meaningful reduction" in petitioner's interest in the continuing enterprise (Pet. App. A9).

The court of appeals reversed (Pet. App. A12-A26). As it observed, the "meaningful reduction" test of *Davis* was employed with respect to the stock redemption of a single corporation and cannot be indiscriminately applied in the context of a reorgani-

zation. In so ruling, the court stated that "[a] contrary holding would render § 356(a)(2) virtually meaningless when a large corporation swallows a small one in a reorganization, for there will always be a marked decrease in control by the small corporation's shareholders, unless the same shareholders control both corporations" (Pet. App. A20).

1. The court of appeals correctly held that the cash distribution received by petitioners in connection with the merger of LSC into MGIC was taxable as a dividend under Section 356(a)(2). Section 356(a)(1) of the Code provides that if, in connection with a corporate reorganization as defined in Section 368, a shareholder receives not only stock in a corporation a party to the reorganization, but also money or other property, the shareholder shall recognize gain in an amount not in excess of the money or other property. Section 356(a)(2) provides that if the exchange has "the effect of the distribution of a dividend," then each distributee shall treat as a dividend such an amount of the gain recognized that is not in excess of his ratable share of the earnings and profits of the corporation.

The decision below is in accord with an unbroken line of authority since the enactment of the predecessor of Section 356(a)(2) as Section 203(d)(2) of the Revenue Act of 1924, ch. 234, 43 Stat. 257. These decisions uniformly hold that where the shareholders of one of the corporations participating in a reorganization receive in exchange not only stock but also a

pro rata distribution of cash, the pro rata distribution of cash has the effect of a dividend.[2] A number of these decisions relied upon the legislative history that accompanied the Revenue Act of 1924. The pertinent committee reports state that if, in the course of a reorganization, a distribution of cash is made to the shareholders of one of the participating corporations, and the distribution would have been a dividend if made prior to the reorganization, then it should also be treated as a dividend when made in the course of the reorganization. H.R. Rep. No. 179, 68th Cong., 1st Sess. 14-15 (1924); S. Rep. No. 398, 68th Cong., 1st Sess. 15-16 (1924).

Given the clearly articulated intent of Congress, the court of appeals correctly recognized that Section 356(a)(2) requires a determination whether the distribution would have been taxed as a dividend if made prior to the reorganization or if no reorganization had occurred. Here, prior to the merger, LSC had retained earnings of approximately $725,000. In the course of the merger, its shareholders received a

[2] *E.g., Commissioner* v. *Owens*, 69 F.2d 597 (5th Cir. 1934); *Commissioner* v. *Forhan R. Corp.*, 75 F.2d 268 (2d Cir. 1935); *Rose* v. *Little Investment Co.*, 86 F.2d 50 (5th Cir. 1936); *Love* v. *Commissioner*, 113 F.2d 236 (3d Cir. 1940); *Hawkinson* v. *Commissioner*, 235 F.2d 747 (2d Cir. 1956); *Ross* v. *United States*, 173 F. Supp. 793 (Ct. Cl.), cert. denied, 361 U.S. 875 (1959); *King Enterprises, Inc.* v. *United States*, 418 F.2d 511, 519-521 (Ct. Cl. 1969); *Woodward* v. *Commissioner*, 23 B.T.A. 1259 (1931); *Woodard* v. *Commissioner*, 30 B.T.A. 1216 (1934); *Sheldon* v. *Commissioner*, 6 T.C. 510 (1946); *Estate of Hill* v. *Commissioner*, 10 T.C. 1090 (1948).

pro rata distribution of $625,000 in cash. If the merger had not taken place and LSC had made such a distribution or if LSC had made the distribution prior to the merger, it is beyond dispute that the cash would have been a dividend taxable at ordinary income rates. Section 356 requires the same result where the shareholders receive the cash pursuant to the terms of the merger. Under the statute, it makes no difference that the shareholders receive the cash after the consummation of the merger rather than as a dividend prior to the merger. In both cases, Congress determined that the distribution was a dividend taxable as ordinary income.

2. Contrary to petitioner's assertion (Pet. 8-11), this Court's decision in *United States* v. *Davis*, 397 U.S. 301 (1970), supports, rather than conflicts with, the decision below. *Davis* arose, not under Section 356, but under Section 302, which deals with the redemption of the stock of a single corporation and provides, *inter alia*, for dividend treatment of the proceeds of the redemption if it is "essentially equivalent to a dividend" (Section 302(a) and (b)(1)). The fact that Section 356(a)(2) employs the phrase "has the effect of the distribution of a dividend" shows that Congress mandated dividend treatment for pro rata distributions in redemptions and reorganizations. But apart from this common attribute between the two provisions, they are not identical and the distinct transactions which they address call for

different analyses and application.[3] Section 302 applies to redemption of the stock of a single corporation. On the other hand, Section 356 applies to reorganization transactions which (except for recapitalizations) necessarily involve two or more corporations. Given these differences in factual contexts, the test of *Davis*—that a redemption must result in a "meaningful reduction" of the shareholder's proportionate interest in the corporation in order to obtain preferred capital gain treatment—is not freely transferable to the context of a merger or consolidation transaction involving two or more corporations. As the court of appeals properly pointed out (Pet. App. A19-A20), a simple comparison of the premerger fractional interests of shareholders in separate and autonomous corporations with their post-merger interests in the single united corporation would almost invariably show substantial reductions in individual

[3] See *Commissioner* v. *Estate of Bedford*, 325 U.S. 283 (1945). There are a number of specific differences between the two provisions. Section 356(a)(2) subjects to dividend treatment not more than the gain recognized on the exchange, while Section 302 applies dividend treatment to the whole amount distributed, even though, computed as an exchange, the exchange results in a loss rather than a gain. Dividend equivalence under Section 302 is determined by application of the attribution rules of Section 318. These attribution rules are not applicable to the determination under Section 356 (a)(2). Finally, only the earnings of the corporation whose shareholders receive cash are available for dividend treatment under Section 356(a)(2). If the two corporations were regarded as one, as under Section 302, the earnings of both corporations would be available.

fractional interests, particularly where, as here, a small enterprise was merged into a large corporation. For if that were the appropriate analysis, Section 356(a)(2) would be rendered substantially meaningless since there would, as here, almost always be a marked reduction in percentage holdings. Thus, in the reorganization context, the appropriate inquiry under Section 356 is whether there was a pro rata distribution of cash to the shareholders of one of the merging corporations. If, as in the instant case, there was such a pro rata distribution, the decisions uniformly hold that the distribution has the effect of a dividend.

3. Contrary to petitioner's further argument (Pet. 11-13), the decision below does not conflict with *Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973). There, the taxpayer and a business associate managed three corporations in related enterprises, and owned stock in them in different proportions. They wished to unite two of the corporations into a single entity so that their interests in the resulting corporation would be in approximately the same proportion as their interests in the other corporation. Because one of the two corporations was worth twice as much as the other, the parties could not accomplish their goal through a simple merger. It was accordingly necessary for the taxpayer to reduce his interest in the resulting corporation. This was done by the payment of cash to the taxpayer to reflect his greater entitlement and to produce a new entity with the

desired percentage holdings. Since the taxpayer was the principal stockholder in both corporations, the court treated the transaction as though there had been a single corporation throughout, and as though the taxpayer's interest in that hypothetical single corporation had been redeemed and reduced. Accordingly, the court employed the *Davis* test applicable to stock redemptions of single corporations.

As the court of appeals observed (Pet. App. A19), application of the "meaningful reduction" test in *Wright* was not illogical given the court's recasting of the transaction. Whether or not *Wright* was correctly decided, the court below correctly concluded that its particularized facts provide no model for the treatment of independent and autonomous corporations with different shareholders. Absent the commonality of ownership that existed in *Wright*, there is no basis for recasting the transaction in the instant case as a redemption. *Wright* is therefore distinguishable. Indeed, in an earlier decision where two corporations with the same shareholders were unified by virtue of a reorganization transaction, the court below recognized that such a situation called for an analysis different from that normally appropriate under Section 356(a)(2). See *Davant* v. *Commissioner*, 366 F.2d 874 (5th Cir. 1966), cert. denied, 386 U.S. 1022 (1967).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. McCREE, JR.
Solicitor General

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